INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	1
Statutes involved	2
Statement	2
Argument	4
Conclusion	9

CITATIONS

Cases:

Dixon v. *United States*, 333 F. 2d 1016, petition for certiorari pending, No. 486, this Term. 4, 5, 7, 9

Lubin v. *Commissioner*, 335 F. 2d 209 7

United States v. *Midland-Ross Corp.*, 335 F. 2d 561, petition for certiorari pending, No. 628, this Term 4, 5, 9

Statutes:

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed):

Sec. 61(a) 2

Sec. 1222(3) 2

Miscellaneous:

Surrey & Warren, *Federal Income Taxation* (1960) 6

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 620

REAL ESTATE INVESTMENT TRUST OF AMERICA, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (Pet. 20–26) is reported at 40 T.C. 921. The opinion of the court of appeals (Pet. 11–18) is reported at 334 F. 2d 986.

JURISDICTION

The judgment of the court of appeals was entered on July 28, 1964 (Pet. 19). The petition for a writ of certiorari was filed on October 26, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether, if the excess of the face amount of a note over the amount of money for which it was issued

represents compensation for the use of the money, the portion of the proceeds of the lender's subsequent sale of the note which is attributable to the excess is taxable as ordinary income or as capital gain.

2. Whether, on the facts of this case, the courts below properly found that the excess did represent compensation for the use of money rather than something else.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed):

> § 61. GROSS INCOME DEFINED
>
> (a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: * * * (4) Interest; * * *.
>
> * * * * *
>
> § 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.
>
> For purposes of this subtitle—
>
> * * * * *
>
> (3) *Long-term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months * * *.

STATEMENT

In May 1948, the Boston Chamber of Commerce Realty Trust ("Commerce Realty") was indebted to the Prudential Life Insurance Company ("Prudential") in the amount of $3,500,000 principal plus over $500,000 of unpaid interest. The debt was evidenced

by a note secured by a first mortgage on Commerce Realty's building, fixtures, and rents. The note was in default and Prudential threatened to foreclose unless the debt was substantially reduced (Pet. 12).

On May 12, 1948, the following occurred: Commerce Realty issued its note in the face amount of $1,000,000 to petitioner. The note bore interest at the rate of 4%, was payable on September 26, 1952, and was secured by a second mortgage on the building, fixtures, and rents. In exchange, petitioner paid $500,000 to Prudential and agreed to pay an additional $200,000 to Prudential at a later time. Prudential in turn reduced the amount owing on its note from Commerce Realty to $3,000,000 and extended the time for payment until September 26, 1952. In short, petitioner paid or agreed to pay a total of $700,000 to Prudential on Commerce Realty's behalf in exchange for a note from Commerce Realty in the face amount of $1,000,000 plus 4% stated interest (Pet. 12).

By subsequent agreements, the due date of petitioner's note was extended to September 26, 1959, with the stated interest rate for the period of the last extension being increased to 6%. The stated interest was paid currently and by November 1958 petitioner had also received payments on the face amount of the note totalling $250,947. On November 25, 1958, petitioner sold the note for $719,053 ($30,000 less than the balance remaining due). Shortly thereafter, a sale of the building previously negotiated by Commerce Realty was consummated, and the purchaser

of the building paid the full amount remaining due on the note to the new holder (Pet. 13–14).

Petitioner's gain on the sale of the note was $270,000.[1] Reporting its income on the cash basis, petitioner treated the gain on its return for the year of the sale as long-term capital gain. The Commissioner determined that the $300,000 excess of the face amount of the note ($1,000,000) over the amount of money advanced by petitioner on the debtor's behalf ($700,000) represented compensation for the use of the money to be treated as interest. Since the gain on the sale of the note was attributable entirely to the maturing of the right to be paid that excess, he treated the entire gain as ordinary income (Pet. 14). The Tax Court (Pet. 20–26), affirmed by the court of appeals (Pet. 11–18), upheld the resulting deficiency.

ARGUMENT

1. The first question presented is identical to that presented by the pending petitions for certiorari in *Dixon* v. *United States*, No. 436, and *United States* v. *Midland-Ross Corp.*, No. 628—to wit, whether bargained-for consideration for the use of money ceases to be treated as "interest" for tax purposes simply because it is not labeled as such and is instead in the form of an increase in the face amount of a note over

[1] Its total proceeds from the note (apart from the current payments of the stated interest) were $970,000, consisting of $250,947 in payments on the note plus $719,053 in sale proceeds. In exchange for the note, it had paid Prudential a total of $700,000 ($500,000 initially plus $200,000 to be paid at various times, payment of which was completed upon petitioner's sale of the note). The difference is the net gain of $270,000.

the amount of money for which it was issued. For the reasons stated in our response to the petition in the *Dixon* case (an acknowledged conflict of decisions), we do not oppose the petition for certiorari on that question.

2. The *Dixon* and *Midland-Ross* cases involve short-term notes issued at a modest rate of discount (under 4%) by financial institutions of unquestioned solvency. In those cases, there is no claim, nor could there be, that the excess of the amount to be paid over the amount loaned represented anything other than bargained-for consideration for the use of money. In this case, however, petitioner argues alternatively that the discount involved was different in its economic nature from the discount involved in those cases and that it should accordingly not be treated as interest even if interest treatment is upheld in those cases. The additional arguments thus made turn upon an economic analysis of, and the proper characterization to be given to, the particular transaction involved in this case. The issues raised are wholly distinct from the issue on which the conflict has arisen and present no question warranting review by this Court. If certiorari is granted, the grant should be limited to Question 1 as stated in this brief—*i.e.*, the question that is common to this case and to *Dixon* and *Midland-Ross*.

a. It is of course true that the form of a promise to pay money does not necessarily determine its economic character or its proper tax treatment. If, for example, *A* agreed to pay *B* 20% interest on a loan only because *B* was his son, some part of the payments ought ob-

viously to be treated as a gift notwithstanding the "interest" label. Similarly, under "thin capitalization" principles, instruments in the form of "notes" with stated interest are often treated for tax purposes as actually representing an "equity" rather than a "debt" interest, with the consequence that the purported "interest" payments are treated as nondeductible "dividends."[2] And what is true of notes with stated interest may equally be true of notes issued at a discount. Thus "original-issue discount" does not *necessarily* represent interest on indebtedness any more than stated "interest" does. In either case, an economic analysis of the particular transaction might lead to the conclusion that the promised payment should be characterized as something entirely different from "interest"—*e.g.*, as a gift, as a dividend, as compensation for services, as payment for a capital asset, or as any other kind of payment which taxpayers might choose to cast in the form of "interest" or of "original-issue discount."

But while we thus agree with petitioner that the form of the transaction does not *per se* establish that the additional $300,000 to be paid should be treated as interest, the courts below did not, as petitioner contends, hold that it did. In stating the general principle, the Tax Court said only that *"In the absence of evidence to the contrary,* original issue discounts are usually treated as additional compensation for the use of the lender's money" (Pet. 26, emphasis added).

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[2] See Surrey & Warren, *Federal Income Taxation*, pp. 1187–1204 (1960).

It held that the gain realized by petitioner "was essentially compensation for the use of its money," not because that is necessarily true of all original-issue discounts, but only because "there is no evidence in the record to support a finding that the discount in this case reflected elements or factors having no relation to interest" (Pet. 26). And it was specifically on the basis of that finding that the court of appeals affirmed the decision (Pet. 17). There is thus no conflict with the decision in *Lubin* v. *Commissioner,* 335 F. 2d 209 (C.A. 2), holding that a promised payment of an amount greater than the sum of money advanced *may,* in particular circumstances, represent something other than interest on indebtedness.[3] And whether the particular facts of this case might have justified a different characterization of the transaction[4] is obviously not a question warranting review by this Court. Indeed, it is for just that reason—that it involves only a question of the proper characterization of the particular "hybrid" transaction in issue—that the government is not filing a petition for certiorari in the *Lubin* case.

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[3] In *Lubin*, the Second Circuit, although reaffirming its view announced in *Dixon* that original-issue discount must normally be accounted for as interest, held that on the unique facts of that case the excess amount to be paid under the "note" over the sum advanced did not represent interest for the use of the taxpayer's money but rather a participating share in the profits from a joint venture for the purchase of some stock which was believed to have been undervalued by the seller.

[4] What alternative characterization of the transaction petitioner is claiming is unclear.

b. Petitioner contends that, because the proceeds of its loan were paid directly to Prudential to refinance a prior debt, its note should be treated as representing, not a new note issued by Commerce Realty at an original-issue discount, but an assignment, at a "market" discount, of a portion of the debt already owing to Prudential. The stipulated facts show, however, that the portion of the prior debt in excess of $3,000,000 was extinguished, with Prudential's note being reduced in amount and continued in force Petitioner did not take advantage of the rate of interest charged by Prudential and simply buy, at a depreciated price, a part of Prudential's claim with its accrued interest, but instead made a fresh advance to Commerce Realty of its own funds, on new terms, for which it charged an independent rate of interest (Pet. 12; R. 4–7). That the amount advanced was used by Commerce Realty to refinance a prior debt does not make the advance any less of a loan to Commerce Realty or entitle petitioner to preferential treatment of the *quid pro quo* it received for making the loan. In any event, both courts below concluded that the transaction was but "a borrower-lender arrangement with the note evidencing an ordinary type of loan" (Pet. 17, 26), and that question of the proper characterization of the transaction on the particular facts presents no question of general principle warranting review by this Court.

CONCLUSION

The *Dixon* and *Midland-Ross* cases (Nos. 486 and 628) present the basic question on which there is a conflict—and the only question warranting resolution by this Court—in an almost classically simple form, unclouded by the additional issues, based on the particular facts, which petitioner seeks to raise here. It is suggested, accordingly, that certiorari should now be granted only in those cases and that action on the petition in this case should be postponed pending their final disposition. If the judgment in the *Dixon* case is affirmed and that in *Midland-Ross* is reversed, the petition in this case should then be denied. If the judgment in *Dixon* is reversed and that in *Midland-Ross* is affirmed, the petition in this case should then be granted and the judgment below reversed. Alternatively, if the Court wishes to hear argument also in this case, the grant of certiorari should be limited to Question 1 as stated in this brief.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.
LOUIS F. OBERDORFER,
Assistant Attorney General.
WAYNE G. BARNETT,
Assistant to the Solicitor General.
JOSEPH KOVNER,
Attorney.

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